

Indiana Department of State Revenue

Revenue Ruling # 2006-04IT

August 18, 2006

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

Adjusted Gross Income Tax
Taxation of Regulated Investment Companies

Authority: Federal Internal Revenue Code § 63, 851, 852, ; IC 6-5.5-1; IC 6-3-1.

The taxpayer requests the Department to rule as to the proper taxation of mutual funds classified as a RIC for federal income tax purposes, specifically whether it is subject to financial institutions tax ("FIT") or adjusted gross income tax ("AGIT").

STATEMENT OF FACTS

The taxpayer is the parent of a group of companies engaged in the financial services business. The headquarters of the taxpayer's operation is located outside Indiana, however, the taxpayer has significant operations within the State. Furthermore, the taxpayer currently operates a family of mutual funds ("Funds") which are organized as separate series of the taxpayer's Insurance Product Trust ("Trust"), a Delaware statutory trust.

The Trust is registered under the Investment Company Act of 1940, as amended, as an open-end management investment company, and each fund is a separate series of Trust. Pursuant to § 851 (g) of the Internal Revenue Code, each fund maintains its books and records in accordance with the accrual method of accounting and reports its taxable income on Form 1120-RIC. Each fund represents a separate investment portfolio for variable annuity and variable life insurance products offered by the taxpayer. Each fund is wholly-owned by one or more separate accounts of Shareholders.

The Funds elected on their federal income tax returns in their initial tax year and qualified to be treated as regulated investment companies ("RICs") under § 851 of the Internal Revenue Code and have maintained their election and qualification as RICs in each tax year thereafter. The Funds intend to continue to qualify as RICs.

The principal office of the Funds is located outside of Indiana; however the taxpayer is considering moving the principal office of the mutual funds, together with the primary administrative functions relating to such funds, to a location within the State. Moreover, the funds the taxpayer is considering moving to a location within Indiana consist largely of stocks (producing dividends and capital gains as the principal forms of income) or bonds (producing interest income and capital gains).

Finally, the taxpayer has, in addition to the aforementioned insurance funds, a retail mutual fund complex that is domiciled outside the State and has recently acquired additional insurance funds organized as Maryland corporations.

DISCUSSION

The Department has previously ruled that money market mutual funds are subject to FIT. Additionally, the Department has ruled that the mutual funds should calculate their adjusted gross income by reference to their federal taxable income under § 852 of the Internal Revenue Code. That provision permits a deduction for distributions to shareholders under § 852(b), among others listed therein.

An entity is classified as a taxpayer for purposes of FIT only if it is (1) a bank holding company, (2) a regulated financial corporation, (3) a subsidiary of a bank holding company or a regulated financial corporation, or (4) a corporation that derives 80% or more of its gross income from making loans or extending credit. (IC 6-5.5-1-17).

The taxpayer asserts that the Funds it is proposing to move to a location within the State will not fall within the definition of a taxpayer for FIT purposes because they will not be entities described in (1) through (3) and will not derive 80% or more of their gross income from making loans or extending credit. Therefore, per the taxpayer's assertion, the Funds tax treatment in Indiana must be evaluated under the adjusted gross income tax laws.

Section 852(b)(1) of the Internal Revenue Code provides that tax is imposed on a RIC by using "investment company taxable income" as the definition of taxable income. Consistent with IC 6-3-1-10 which defines "Corporation" to include all corporations including a RIC and IC 6-3-1-11(c)(2) which provides for corporate taxable income to be defined as it is in § 63 of the Internal Revenue Code. This definition of taxable income allows a deduction for dividends paid under § 852 (b)(2)(D) and for capital gain dividends under § 852(b)(3)(A).

The Internal Revenue Code treats a RIC as a conduit for investment income earned and distributed to its shareholders. "A RIC is generally taxed as a pass through entity." *See* "Taxation of Regulated Investment Companies," BNA Tax Management Portfolio 740 at A-1. The Internal Revenue Code implements this approach by allowing the RIC to claim deductions for dividends paid to its shareholders, who report the passed-through income on their own returns. The character of the income or gain generated by the RIC is passed through to shareholders along with these distributions. Thus, a RIC does not generally pay federal income tax as long as it distributes all its income to its shareholders in the form of dividends.

If the RIC were not allowed the dividends paid deduction under § 852, there would be the potential for double taxation at the entity level and shareholder level. This result would run contrary to the general treatment of a RIC as a pass-through entity. It should also be noted that the federal tax treatment of a RIC is substantially similar to that of the real estate investment trusts (“REITs”) and that the Department has ruled that for AGIT purposes, REITs start with their “real estate investment trust income.”

RULING

The Department rules that the taxpayer, a RIC, may use the definition of investment company taxable income in § 852 of the Internal Revenue Code as the starting point in computing adjusted gross income and is entitled to the dividends paid deduction and other applicable deductions provided by § 852(b) of the Internal Revenue code.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer’s facts and circumstances, as stated herein are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling a change in statute, regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

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